Developmental venture capital: conceptualizing the field

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Developmental venture capital is the financing of businesses with equity and near-equity in order to achieve both social and financial objectives. The social returns include economic development of distressed urban and rural geographies; creation of high-quality jobs for low-income populations; building wealth for women and people of color; and creation of products that benefit society, such as those that lower poverty or contribute to a cleaner environment. This article introduces a conceptual framework for the developmental venture capital industry based on the social objectives of individual funds. The framework distinguishes between funds that have corrective versus additive objectives. Funds with corrective objectives are designed to address inadequate access to traditional venture capital by specific geographies and populations. Funds with additive objectives are meant to further specific social goals, such as fighting poverty or environmental degradation. This framework further differentiates between two forms of corrective venture capital, based on the capital access obstacles that each is trying to address and whether the resulting economic models require subsidy.

Keywords: developmental venture capital; social entrepreneurship; community development venture capital; public venture capital; social venture capital

The venture capital industry invokes images of wealthy investors earning significant profits by providing equity capital to rapidly growing companies. Yet from its beginnings, the industry has had social as well as financial objectives. American Research and Development (ARD), the first ‘modern venture capital firm’, which helped create the current ‘venture capital paradigm’, was designed not to make money but to finance ‘noble ideas’ (Gompers 1994, 6). ARD’s first investment was in a company working to develop X-ray technology for cancer treatment. In describing why he thought ARD should invest in the firm, MIT president Karl Compton, one of ARD’s four co-founders, said to fellow co-founder and ARD President General Georges F. Doriot, that the firm ‘probably won’t ever make any money, but the ethics of the thing and the human qualities of treating cancer with X-rays are so outstanding that I’m sure it should be in your portfolio’ (Lample 1989, as quoted in Gompers 1994, 6).

This view of venture capital as a way to generate socially beneficial objectives was shared by other early venture capitalists. For example, Peter Brooke, chair of

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the global venture capital firm Advent International and a pioneer in the industry, stated that ‘Regional economic development has driven my whole career. I loved doing deals, but basically I’ve used venture capital as a tool to increase economic value, here and abroad. I never thought of it as a way to make a lot of money’ (Allis 2001, A2).

Much of the domestic venture capital industry has moved away from this perspective to one that focuses on value creation through financial returns. There are more developmental sectors of the industry, however, for whom social objectives continue to be as important as financial ones. These social objectives include economic development of distressed urban and rural geographies; building of wealth for women and people of color; creation of high-quality jobs for low-income populations; and generation of products benefit society, such as those that lower poverty or contribute to a cleaner environment.

The developmental venture capital (DVC) industry has grown significantly over the last two decades, and now has almost $20 billion in capital under management. Yet we know relatively little about this industry. Research on venture capital funds that overtly pursue social objectives has tended to focus on a particular sub-sector of the developmental venture capital industry – minority-focused venture capital, state-sponsored venture capital, community development venture capital and social venture capital – rather than seeing each of those as part of a broader field.

The developmental venture capital industry also lacks an explanatory theoretical framework. Prior efforts either have treated the different sub-sectors of developmental venture capital as interchangeable (Yago, Zeidman, and Abuyuan 2007), or have categorized them on the basis of their legal form (Waddell 1995); size, age or level of profit orientation (Daniels and Nixon 2003; Clark and Gaillard 2003). By focusing on such largely descriptive differences, these approaches have failed to provide actionable insights into the behavior of individual developmental venture capital funds.

This article introduces a conceptual framework for the developmental venture capital industry based on the social objectives of individual funds. The framework distinguishes between funds that have corrective versus additive objectives. Funds with corrective objectives are designed to address inadequate access to traditional venture capital by specific geographies and populations. Funds with additive objectives are meant to further specific social goals, such as fighting poverty or environmental degradation. This framework further differentiates between two forms of corrective venture capital, based on the capital access obstacles that each is trying to address and whether the resulting economic models require subsidy.

This article proceeds as follows. Part I reviews the recent literature on the developmental venture capital industry. Part II lays out the history and current composition of each of the industry’s four sub-sectors. Part III introduces and explains the conceptual framework. Part IV discusses the implications of this framework for both public policy and practice.

Part I: Reviewing the literature

Most prior literature on developmental venture capital has focused on describing and analyzing one of the field’s four sub-sectors: public, minority-focused, community development or social venture capital. There have, however, been four prior
efforts to design a classification system that cuts across multiple sub-sectors in order to offer insights for the industry as a whole.

Steven Waddell (1995) provided the first such analysis of developmental venture capital. He examined nine ‘socially guided venture capital organizations’ and classified them into four types, based on their organizational and legal structures: socially guided venture capital networks; socially guided private funds; Specialized Small Business Investment Companies and equity community development corporations (CDCs) (Waddell 1995, 324).

While Waddell’s study provides a useful description of the early developmental venture capital industry, his categories fail to capture meaningful differences between the nine funds that he studied. Part of the problem is his typology’s lack of precision. For example, two of the Small Business Investment Companies were also equity CDCs, yet Waddell’s typology does not provide guidance as to how to treat organizations that belong to multiple organizational types.

More importantly, Waddell’s focus on the organization’s legal forms masks more substantive similarities and differences that exist among the funds. For example, six of the nine organizations (belonging to three of Waddell’s four categories) share a focus on the economic development of distressed communities and job creation for low-income populations, and self-identify as community development venture capital funds. Conversely, Waddell’s conflation of Small Business Investment Companies and Specialized Small Business Investment Companies into a single category masks real differences in objectives and economic models between the two. Overall, Waddell’s analysis fails to recognize that the different legal forms used by the nine organizations reflect the heterogeneity commonly found in a young organizational field rather than fundamental distinctions that could facilitate behavioral predictions (Rubin 2002).

Catherine Clark and Josie Gaillard (2003) defined the relevant universe of organizations more broadly than Waddell, surveying 1254 venture capital funds that . . . [had] put dollars into ventures acting in one of our 10 social or environmental interest areas, or [had] . . . indicated in other ways that they try to affect social or environmental problems through their investment activities. (Clark and Gaillard 2003, 3)

The 59 venture capital funds that responded to the survey and passed Clark and Gaillard’s screens had to

invest at least 1% of their assets through equity; have at least one office located in the U.S., or invest at least partially in the U.S.; be involved in early-stage investing defined as seed- through expansion-stage; [and] be incorporated as an institutional investor, operating as a stand-alone or subsidiary. (ibid, 3)

On the basis of the data they collected, Clark and Gaillard categorized the 59 funds into four groups.

The VC with a Conscience – markets itself as a mainstream venture capital (VC) fund, but has made a commitment internally to devoting some portion of capital . . . to deals or to entrepreneurs with explicit social or environmental goals.

The Industry Change-Focused VC Fund – invests in an industry niche in which the primary product or service of the business is inherently pro-social or pro-environmental, for example in charter schools or renewable energy technologies.
The Leadership- or Development-Focused VC Fund – invests in businesses whose social purpose is accomplished not by the product or service they provide, but by who owns or manages the business, where it is located, or whom it employs . . . includes funds that work to create jobs in low-income areas, invest in minority- or women-led companies, and invest in economically depressed areas.

The Nonprofit Social Investment Fund . . . exists within a private foundation or public charity legal form and makes equity investments in private companies as a means to support the mission of the nonprofit entity. (ibid, 6–7)

Clark and Gaillard’s analysis highlights some of the challenges of collecting data on an emerging and highly diverse organizational field via a written survey. Because the field boundaries were unclear, Clark and Gaillard set fairly loose parameters for inclusion. For example, they included venture funds on the basis of their industry specialization in environmental or energy products. While such ‘green’ investments were initially considered to be on the socially oriented fringe of traditional venture capital, by 2007, they accounted for more than 7% of all venture capital investments and were led by some of the most established traditional venture capital firms (Celaschi 2008). Clark and Gaillard also included funds that invested as little as 1% of their capital in equity. This is problematic because the organizational and economic models utilized by organizations that make primarily debt investments are substantially different from those that primarily invest equity (Rubin 2008a).

Another challenge for Clark and Gaillard was convincing busy venture fund managers who tend to guard their privacy to respond to a survey and provide in-depth information about their funds.

Not surprisingly, only 6% of the surveyed venture funds responded. Given the survey’s low response rate and the heterogeneity of the field Clark and Gaillard were surveying, there is no way to know if the funds whose managers answered the survey were a representative sample of the broader universe. The fairly limited data the survey provided about the funds also made it difficult to draw substantive conclusions about the field.

As a result, Clark and Gaillard ended up classifying the 59 funds based on the intensity of their social objectives and how explicit they were about those objectives. While interesting, such a classification is largely descriptive versus predictive, and does not enable Clark and Gaillard to hypothesize about a given venture’s fund’s behavior.

In contrast, Belden Daniels and James Nixon (2003) approached developmental venture capital in the context of a larger universe of financial intermediaries. They classified the organizations in this universe as belonging to either first or second generations on the basis of their for-profit or nonprofit status; size; level of subsidy and financial returns; and whether they made debt or equity investments.

Daniels and Nixon describe first generation organizations as ‘smaller, below-market, grant and debt funds’, the ‘great majority’ of which are nonprofit in legal form (Daniels and Nixon 2003, 1). These entities sought ‘to supplement the market, making socially and environmentally important investments at a below-market cost of capital to investment recipients and a below-market return on investment to investors’ (ibid, 2). Daniels and Nixon point to community development financial institutions (CDFIs), which include community development banks, venture funds, credit unions and loan funds, as the embodiment of first generation organizations.

Contrasting these ‘first generation’ organizations with second generation ones, Daniels and Nixon argue that ‘second generation “double bottom line” market-rate
Community funds’ are larger, ‘designed to attract large-scale capital managed by proven fund managers with outstanding track records. Community sponsors structure the funds to provide investors with market returns and community stakeholders with community revitalization and measurable job and wealth creation’ (ibid, 3). Daniels and Nixon estimate that the second generation funds are divided roughly 60/40% between real estate equity funds focused on mixed-income and mixed-use housing, commercial, and industrial development that rebuild inner city neighborhoods (60%), and business equity funds focused on the rapid expansion of businesses enterprises that can make a measurable impact of job and wealth creation in these same neighborhoods (40%). (ibid, 3)

The main problem with Daniels and Nixon’s approach is that they base their classification system on vague and at times inaccurate generalizations. This lack of precision is illustrated in the diverse set of organizations that they combined under the first and second generation umbrellas. These organizations differ from each other on many important criteria that make them difficult to describe in aggregate. For example, the first generation organizations included community development banks, credit unions, loan funds and venture capital funds. These entities have different sources of capital, levels of regulation, for-profit or nonprofit status, and functions (e.g. whether they take deposits, make loans or make equity investments). Daniels and Nixon’s second generation category, which combines real estate and business equity funds, is equally vague as these funds differ from each other significantly in their economic models and levels of risk.

Because the first and second generation categories are so broad, many of the specific claims made by Daniels and Nixon do not hold up. For example, their argument that first generation organizations make grant and debt versus equity investments is difficult to understand in light of the fact that community development banks, credit unions and loan funds are not intended to make equity investments. In fact, community development banks and credit unions are regulated depository institutions that are prohibited from making equity investments. Only community development venture capital (CDVC) funds can be compared with second generation business and real estate equity funds on the nature of their investments, and the majority of CDVC funds invest equity, just like their second generation counterparts.

Daniels and Nixon’s description of first generation organizations as ‘smaller’ than second generation ones and their claim that the great majority of first generation organizations are nonprofit in legal form are also inaccurate. For example, Daniels and Nixon highlight the $20 million Fulcrum Capital Fund as an example of a second generation business equity fund. However, eight community development venture capital funds have $20 million or more under management, as do more than 25 community development loan funds and a few community development credit unions, making them comparable to or larger than Fulcrum Capital (Rubin 2008b, 2009). The median community development bank is significantly larger than that, with more than $135 million in assets (CDFI Data Project 2006). Nor are the great majority of community development financial institutions nonprofit in legal form. All community development banks (CDBs) and the majority of community development venture capital funds (CDVC) use a for-profit legal structure (CDFI Data Project 2006; Rubin 2009).

Even Daniels and Nixon’s broader point – that first generation organizations made investments ‘at a below-market cost of capital to investment recipients and a
below-market return on investment to investors’ (Daniels and Nixon 2003, 2) while second generation funds provide investors with ‘market returns’ – is not accurate. Community development financial institutions do rely, in part, on subsidized capital, but so do the organizations classified as second generation by Daniels and Nixon. For example, a number of the business and real estate equity funds identified by Daniels and Nixon as second generation received public sector subsidies via the Certified Capital Company and New Markets Tax Credit programs, while those second generation funds that received investments from commercial banks benefited from regulatory subsidy via the Community Reinvestment Act. Nor is it accurate to claim that all investors in community development financial institutions receive below-market returns. Some CDFI investors, including governments, foundations and certain banks, provide subsidized capital while others are compensated at market rates, as is the case for investors in those funds that Daniels and Nixon classified as second generation. In fact, it’s difficult to find any significant differences between the organizations that Daniels and Nixon classified as second versus first generation.

Most recently, Glenn Yago, Betsy Zeidman and their colleagues at the Milken Institute (2007) categorized developmental venture capital funds solely on the basis of their target market. Specifically, they focus on whether the funds invest in ‘emerging domestic markets’, which consist of:

- ethnic- and women-owned firms, urban and rural communities, companies serving low-to-moderate-income populations, and other small- and medium-sized businesses
- people of color (African-Americans, Latinos/Hispanics, Asian Americans/Pacific Islanders and Native Americans), women and low-to-moderate-income communities (LMI) (both businesses located there and firms owned by LMI entrepreneurs).

The Milken researchers claim that the primary reason that such markets face capital constraints is information asymmetries – the lack of robust data on the markets. Without comprehensive, reliable demographic and financial information, financial decision makers, business leaders and public policy officials are unable to price risk and evaluate opportunities effectively. (Yago, Zeidman, and Abuyuan 2007, 3)

According to the Milken researchers, such ‘emerging domestic markets’ are served by three types of developmental equity funds – minority-focused venture capital funds; community development venture capital funds; and the second generation business and real estate equity funds identified by Daniels and Nixon (Yago, Zeidman, and Abuyuan 2007).

There are three important limitations of the emerging domestic markets formulation. First, the Milken researchers treat all underserved communities as interchangeable, not acknowledging that they differ in important ways in the nature and causes of their capital constraints. Second, the Milken researchers claim that underserved communities lack access to capital primarily as a result of information failure, ignoring the numerous other obstacles that raise transaction costs and discourage private sector investment in such communities. Third, the Milken researchers do not differentiate between the minority-focused and community development equity funds that invest in underserved markets and entirely omit state-sponsored funds from their formulation.

By aggregating the various underserved population and geographies under the emerging domestic markets umbrella, the Milken researchers imply that all of them
lack access to capital at comparable levels and for similar reasons – primarily as a result of information failure. In fact, however, these populations and geographies differ from each other in both the nature and causes of their capital constraints. As the literature has consistently documented, an individual’s access to capital varies as a result of numerous factors, including income and educational background (Robles and Cordero-Guzmán 2007); race (Bates 1991, 1997b; Bostic and Lampani 1999; Cavalluzzo and Wolken 2005; Coleman 2002, 2003; Blanchflower, Levine, and Zimmerman 2003; Mitchell and Pearce 2004; Blanchard, Yinger, and Zhao 2004; Cavalluzzo, Cavalluzzo, and Wolken 2002); gender (Greene et al. 2001; Buttner and Rosen 1988; Cavalluzzo and Cavalluzzo 1998; Walker and Joyner 1999; Coleman 2000); ethnicity (Bates 1990; Delgado 1998; Ruiz-Vargas 2000; Carvajal 2004; Mora and Davila 2006); immigrant status and country of birth (Robles and Cordero-Guzmán 2007); geographic location of business (Robles and Cordero-Guzmán 2007); level of attachment to the community (Chaganti and Greene 2002); and potential religious affiliation (Choi 2004).

The reasons that these individuals and geographies are underserved are also diverse and cannot be reduced exclusively to information failure. As detailed in Part III of this article, many underserved geographies must overcome additional obstacles – such as limited investment opportunities, a lack of profitable investment exits, and the absence of a developed investment infrastructure – that raise transaction and operating costs and discourage investment by traditional venture capital funds.

Equally problematic is the Milken researchers’ claim that these markets are served by three types of venture funds – minority-focused venture capital funds; community development venture capital funds; and Nixon and Daniels’ second generation business and real estate equity funds – whose limitations were discussed previously. This conception not only ignores the role of state-sponsored venture capital funds in addressing underserved markets, it also fails to acknowledge the important differences that exist between minority-focused and community development venture capital funds. These differences include the underlying problems each type of venture fund is trying to address and the economic models they utilize to do so, as discussed in detail in Part III of this article. Failing to acknowledge such differences can lead to confusion among policymakers and investors, which hinders the ability of developmental venture capital funds to raise capital and pursue their social objectives (Fairchild 2007).

As the preceding analysis highlights, prior efforts to formulate an explanatory framework for developmental venture capital have shared two overarching limitations. First, they have lacked precision in defining what is developmental venture capital – drawing the parameters for the field either too narrowly (Waddell 1995; Yago, Zeidman, and Abuyuan 2007) or too broadly (Clark and Gaillard 2003; Daniels and Nixon 2003). Second, the resulting classification schemes have differentiated developmental venture capital funds on the basis of characteristics – such as legal form or intensity of social objectives – that are largely descriptive, without determining if those components of the model actually drive fund economics. As a result, these schemes have lacked analytical or predictive value for understanding fund structures and behaviors.

In order to formulate a conceptual framework that overcomes these limitations, it is necessary first to understand the universe of funds that pursue both social and financial objectives, the defining characteristic of the developmental venture capital
field. To date, both literature and practice have identified funds that pursue such dual bottom lines as belonging to one of four sub-sectors: minority-focused venture capital; state-sponsored venture capital; community development venture capital and social venture capital. The next section of this article details what is known about the history, current composition and behavior of each of these sub-sectors while Part III builds on that information to propose a theoretical framework for the industry as a whole.

**Part II: Developmental venture capital’s sub-sectors**

Over the last decade, new research has become available that describes and analyzes the minority-focused and community development sub-sectors of the developmental venture capital industry. The diversity of models utilized by individual states has made it difficult to conduct a comparable analysis for the state-sponsored sub-sector. A partial description can be gleaned, however, from a 2006 survey by that sub-sector’s trade association. Social venture capital, the newest sub-sector, has so far received the least attention from researchers. As a result, the description of social venture funds that follows relies partly on an account of a specific transaction, to highlight how this sub-sector differs from both community development and more traditional venture capital.

**Minority-focused venture capital**

Minority-focused venture capital funds invest predominantly in companies owned by people of color – primarily in black-owned firms, with ‘Hispanic businesses … a distant second … (and) investments in Asian owned firms … least common’ (Bates and Bradford 2007, 100). The industry came into existence as a result of President Richard Nixon’s ‘Black Capitalism’ initiative. In March of 1969, Nixon issued an executive order directing his secretary of commerce to coordinate the federal government’s plans, programs and operations ‘which affect or may contribute to the establishment, preservation and strengthening of minority business enterprises’ (Dingle 1990, 160). This executive order led to the creation of the Minority Enterprise Small Business Investment Companies (MESBICs) program, at the US Small Business Administration. MESBICs were intended to provide minority entrepreneurs with access to equity and debt capital (Bates 2002).

In 1985, MESBICs were renamed Specialized Small Business Investment Companies (SSBICs) and their mission was broadened to serve ‘the needs of entrepreneurs who had been denied the opportunity to own and operate a business because of social or economic disadvantage’ (SBA 2001). In 1996, Congress ended the issuance of new SSBIC licenses, but allowed existing SSBICs to continue operations (SBA 2001). This dramatically reduced the number of funds in existence. As of 30 September 2002, only 42 of the 286 SSBICs licensed over the life of the program were still active. Most of these funds managed small amounts of capital, with a combined total of $119 million and a median size of $2.1 million in private capital under management (SBA 2003). By the end of 2007, only 16 of these SSBICs were still in existence. Five of them made only loans while 11 made equity or near-equity investments. Nine of those 11 had a maximum investment size of $300,000 or less (SBA 2007).
The emergence of non-SSBIC, black-owned venture capital funds dates back to the 1984 founding of UNC Ventures in Boston, Massachusetts. With $18 million under management, it was the largest of the nation’s privately run black-owned venture capital firms (Scott, Reynolds, and Hayes 1994). In the years since UNC Ventures was founded, dozens of additional private, minority-focused venture capital funds have been created (Bates and Bradford 2008).

Beginning in the early 1990s, private minority-focused venture funds were allowed to join the National Association of Investment Companies (NAIC), the SSBIC trade association (NAIC 2003). This influx began to change the NAIC from a trade association of SSBICs to its current mission as an association of private equity funds that ‘invest in businesses that substantially serve ethnically diverse markets; and/or are significantly owned by minority or ethnic individuals’ (NAIC 2008a). Bates and Bradford (2002, 2003a, 2003b, 2007, 2008) and Bates, Bradford, and Rubin (2006) provide the most comprehensive and current information on the industry. They collected data between 2001 and 2005 on NAIC members that were venture capital (versus debt) oriented; invested primarily in minority-owned firms; were for-profit in legal form; invested in the United States, and invested directly in portfolio companies versus serving as a fund of funds. They found that the almost $2 billion raised by these firms through year-end 2003 came primarily from five sources: public pension funds (51%); funds of funds (10.7%); corporations (10.7%); banks (10.2%); and corporate pension funds (9.7%). Smaller sources of capital, which included local, state and federal governments; insurance companies; foundations and endowments; and individuals, collectively provided an additional 7.8% of all capital (Bates and Bradford 2007).

Between 2001 and 2004, public pension funds and funds of funds almost doubled the dollars they committed to minority-focused venture capital by increasing the number of funds they financed while holding the median investment per fund steady. Bates and Bradford concluded that not only ‘the established, successful VC firms’ but also the ‘younger funds lacking track records have increasingly been successful in raising capital from public pension funds and funds of funds’ and that these sources are ‘driving continuing growth in the minority VC sector’ (2007, 99).

Most minority-focused venture capital funds are smaller than traditional venture capital funds, with a median capitalization of less than $30 million versus the more than $200 million median capitalization of traditional venture funds (Bates and Bradford 2008; Venture One 2006). Some of the better established minority venture capital funds, however, have more than $500 million under management (Bates and Bradford 2008). As of the end of 2008, members of the NAIC in aggregate managed more than $10 billion (NAIC 2008b).

Bates and Bradford report that, like conventional venture capital, minority-focused venture funds are extremely selective, investing in only ‘a small subset of the nation’s minority business community . . . commonly target[ing] firms whose owners have strong educational credentials and considerable managerial expertise . . . annual sales in the million-dollar-plus range as well as excellent growth prospects’ (Bates and Bradford 2007, 96). Unlike conventional venture capital, however, most minority funds are not exclusively high-tech oriented, preferring to diversify widely across both high- and low-tech fields (Bates and Bradford 2007). They also take advantage of relationship networks that are different from those utilized by conventional venture capital, and rely on these networks for ‘the bulk of their investment opportunities’ (Bates and Bradford 2007, 106).
The minority-focused venture capital funds analyzed by Bates and Bradford had return objectives similar to those of conventional venture capital and as a group, were very successful in meeting those objectives. After evaluating the financial returns on investments exited through year-end 2003, Bates and Bradford determined that the average internal rate of return for the funds was 17.7%, which was higher than the returns of conventional venture capital funds of comparable vintage (2007).

**State-sponsored venture capital**

State-sponsored venture capital funds are capitalized by individual states in order to give their businesses greater access to equity capital. The states may capitalize such funds directly, through appropriations, or provide incentives, such as tax credits, to attract private sector investors. The venture funds may be publicly managed, or the state may invest as a limited partner in privately managed venture funds in exchange for the managing partners’ promise to invest that capital in-state, or at least make a good faith effort to do so.

The origins of government-sponsored venture capital date back to 1958, when the US Congress created the Small Business Investment Company (SBIC) program. At that time, the domestic venture capital industry was very small and lacked a visible institutional infrastructure, fostering concerns that inadequate levels of venture capital could hinder overall economic growth. SBICs, which make equity and debt investments in small businesses, were intended to stimulate economic development by encouraging individuals to invest in venture capital, thus increasing the supply of financing for small firms (Fenn and Liang 1995). SBICs are privately owned and operated investment companies that are licensed by the US Small Business Administration, which also provides them with access to matching investment capital.

Despite the social objectives behind the creation of the SBIC program, individual SBICs have pursued a fairly traditional profit-oriented bottom line. While they must regularly report to the SBA how many jobs their investments create, their investment decisions are driven primarily or exclusively by profit maximization, like that of most traditional venture capitalists (Rubin 2001).

In the early 1970s, individual states began following the federal government’s lead and capitalizing local venture capital funds in order to encourage small business formation, economic growth and job creation (Eisinger 1991). The first state-sponsored venture capital funds were the Connecticut Product Development Corporation and the Massachusetts Community Development Finance Corporation (Osborne 1990; Eisinger 1988). Prior to their creation, the state approach to economic development had consisted almost entirely of smokestack chasing – the use of tax breaks, public subsidies and relatively low wages to lure existing businesses from elsewhere in the country. Connecticut and Massachusetts bucked this trend in the hope of addressing perceived capital shortages and imperfections in the financial markets.

The Connecticut Product Development Corporation was set up to be ‘much like a private venture capital firm,’ but its objective was to ‘create and preserve jobs, stimulate the innovation process, and encourage the diversification of the state’s defense industries’ (Eisinger 1988, 253). The Massachusetts Community Development Finance Corporation was designed to be ‘a “third-sector” institution with the
policy perspective of government but the marketplace orientation of business' (Osborne 1990, 26). The group responsible for its creation believed that there were ‘potential investments that might not make sense to a private investor concerned only with profits, but would make sense from a public perspective because of the “social return” from tax revenues, lower welfare caseloads, and decreased crime rates’ (Osborne 1990, 26).

In the late 1970s and early 1980s, the idea of state venture capital funds spread to the rest of the nation. This diffusion was aided by a number of studies that came out around that time, indicating that small enterprises were disproportionately responsible for job creation (Birch 1979, 1981; Daneke 1985). These studies also argued that, because of the significant concentration of traditional venture capital by geography, industry and stage of investment, small enterprises had a particularly difficult time obtaining the patient capital they needed to survive and grow (Eisinger 1988).

In response to this information, state economic development officials followed the examples of Connecticut and Massachusetts and set up their own state-sponsored venture funds. These funds were designed to provide equity backing to encourage small business formation by supporting the process of business planning, product development, initial production and marketing (Eisinger 1988). As of 2006, more than 44 states were operating a venture capital fund, investing state funds in privately managed and geographically targeted funds, or providing tax incentives for others to invest within the state. In total, these states had committed approximately $5.8 billion to these programs (NASVF 2006).

As with the first state-sponsored venture funds, most current state programs are intended to help grow the local economy and create jobs. The National Association of Seed and Venture Funds (NASVF), the trade association of state-sponsored venture capital, conducted a 2006 survey of 141 state-sponsored programs in 44 states. It found that the common threads in state-sponsored program mission statements were ‘jobs, competitiveness, and economic growth’. Jobs or economic growth were mentioned as a desired outcome by about half of the NASVF respondents, with job creation ‘mentioned more than any other goal, and . . . twice as often as return on investment’ (2006, 19).

The NASVF survey also found that state-sponsored programs most frequently targeted seed and early-stage companies, with 57% of responders indicating they were willing to fund such firms. This differed from the investments made by traditional venture capital funds in 2006, only 34% of whose investments went to seed and early-stage companies (National Venture Capital Association 2006). State-sponsored funds were more similar to traditional venture funds in the industries they targeted for investment, with Biotech, Medical devices and equipment, Software, Telecommunications and Industrial/Energy being the top five contenders for both (NASVF 2006; National Venture Capital Association 2006).

The 2006 NASVF survey did not ask about the social or financial returns of state-sponsored funds; NASVF planned to conduct a subsequent survey that focused on these questions. In general, the diversity of models utilized by state-sponsored funds makes it difficult to generalize about their performance. The 2006 NASVF survey did ask the program managers how well they thought their programs were working: 42% indicated that their program’s performance had been excellent or above average; 47% indicated it had been average and 12% indicated it had been below average.
Community development venture capital

Job creation and economic growth are also among the objectives of community development venture capital (CDVC) funds. However, unlike state venture funds, which generally target entire states for investment and aim to create jobs for all income levels, CDVCs specifically focus on the revitalization of distressed rural and urban communities and the creation of high-quality jobs for low-income individuals.

This nexus of venture capital and poverty alleviation dates back to the creation of community development corporations (CDCs) in the late 1960s, as a way to respond to inner-city and rural poverty. The early CDCs received federal grants to support a broad range of activities designed to foster economic development in distressed areas (NCEA 1981). Some of the CDCs, such as the Kentucky Highlands Investment Corporation (KHIC), used these funds to begin their own business ventures, and to invest in local businesses owned by others (Miller 1994). Kentucky Highlands, which served a nine county area in Southeastern Kentucky, felt that part of its mission was to ‘spread the word’ about this new approach to community economic development (Miller 1998). It was so successful in this effort that articles about KHIC began appearing in national periodicals such as National Journal, The Washington Post and The Wall Street Journal (Pierce and Hagstrom 1979; Berry 1979; Gigot 1981).

Despite KHIC’s efforts, the number of venture funds focused on poverty alleviation remained small until the mid-1990s, when President Bill Clinton’s administration created the Community Development Financial Institutions (CDFI) Fund in the US Department of the Treasury. The CDFI Fund’s aim is to grow the number and capacity of financial intermediaries serving low-income communities. Venture capital funds with that objective – known as community development venture capital funds – form one branch of what came to be known as the CDFI industry.10

Concurrent with the 1994 creation of the CDFI Fund, a small group of pioneering CDVC funds formed a trade association – the Community Development Venture Capital Alliance (CDVCA) – and began to network and share ideas and models. CDVCA membership grew rapidly in the late 1990s. By the end of the decade, CDVCA was drawing hundreds of potential fund managers and investors to its annual conferences. Additionally, more than 20 CDVC funds were making equity and near-equity investments in companies while many others were at various stages of fundraising but had not yet begun investing (Rubin 2001).

The earliest CDVC funds, such as Kentucky Highlands, were capitalized primarily by federal, state and local governments and by foundations. These sources of capital were limited, however, and newly forming CDVC funds needed to identify additional sources of investment capital. Starting in the late 1990s, that need was increasingly filled by commercial banks. Unlike the early CDVC investors, which were motivated primarily by social objectives, commercial banks invested in CDVCs as a way of meeting their Community Reinvestment Act (CRA) obligations.11 The banks based their investment decisions on the potential financial returns of specific community development venture capital funds as well as the overlap between those funds’ investment geographies and the geographies from which the banks accepted deposits. This encouraged those CDVC funds that were raising capital to increase their investment territories – targeting multi-state rather than multi-county regions – in order to increase the number of banks that overlapped with their investment territory and to boost profitability by increasing the number and thus the quality of
potential investment opportunities. By increasing the geography in which they invested, however, these venture funds reduced their likelihood of having a cumulative economic development effect on any part of that geography (Rubin 2001; Rubin 2008a).

CDVC funds also expanded their social objectives, moving beyond job creation for low-income individuals to include companies that adhered to socially progressive management practices and provided their workers with health care and other benefits; companies owned or managed by women and people of color; and companies that manufactured products beneficial to the environment. In addition to promoting these social objectives, some CDVC funds also applied social screens to potential investments, to eliminate what they felt were socially undesirable products, such as weaponry or gambling (Rubin 2001).

CDVC fund managers broadened their social objectives beyond job creation for low-income individuals because it enabled them to demonstrate greater social impact to their funders. Not only could an individual CDVC fund point to the number of low-income individuals employed by its portfolio companies, it also could tout the quality of those jobs and how many of them went to women and people of color, as well as the broader social benefits of producing environmentally beneficial products or services. Targeting a broader range of social objectives also aligned these CDVC funds with the objectives of a greater number of potential funders, including some – such as wealthy individuals – who may have been less concerned about low-income job creation. Additionally, the broader social objectives reflected the challenge of measuring the economic impact of a venture fund’s investments when its geographic footprint expanded from a number of counties to multiple states (Rubin 2009).

The CDVC industry’s growth began to slow in 2001, as the bursting of the technology bubble led to dramatic declines in venture capital returns and as the newly elected George W. Bush administration signaled a general lack of enthusiasm for community development (Rubin 2007, 2008b). The industry was also hurt by a few high-profile failures and the resulting investor perception that community development venture capital was not profitable (Rubin 2008a, 2009). Only 16 new CDVC funds completed their capitalization after 2000. This included five funds that were part of existing venture fund families and seven funds made possible by the federal New Markets Venture Capital and Rural Business Investment Company programs (Rubin 2009).

Evidence that the CDVC brand had lost some of its luster was also apparent in the increasing reluctance Rubin found among some fund managers previously identified as community development venture capital to be associated with that label. These managers preferred to align their venture funds with the broader category of social venture capital (Rubin 2009).

Rubin studied 40 organizations with approximately $486 million under management, which were making or previously had made equity or near-equity investments with the objective of revitalizing distressed communities and creating high-quality jobs for low-income individuals (2009). Some of these funds also had broader social objectives, as discussed in the social venture capital section of this article.

These funds used a variety of organizational forms to make their investments, including a for-profit, limited life structures comparable to those of conventional venture capital; for-profit evergreen (unlimited life) structures; and nonprofit
structures. The limited-life, for-profit funds tended to be the largest of the three, with an average capitalization of $16.3 million. These funds raised most of their investment capital from commercial banks, which invested as a way of meeting their Community Reinvestment Act obligations, and from the federal government’s New Markets Venture Capital and Rural Business Investment Company programs. The evergreen for-profit funds and the nonprofit organizations had an average capitalization of $5.9 million. They raised their capital primarily from foundations and local, state and federal governments.

The limited-life for-profit funds also varied from the evergreen funds and the nonprofits in their return objectives. The limited-life funds targeted returns comparable with those of conventional venture capital funds while most of the evergreen and nonprofit funds stressed their social objectives and acknowledged that those objectives were likely to reduce their financial returns.

Rubin was not able to calculate financial returns for either group of funds. Most of the limited-life for-profit funds had been in operation for fewer than 10 years, and had yet to exit the majority of their investments. The evergreen for-profit and the nonprofit funds also had not exited the bulk of their investments. Additionally, many of these funds received significant operating subsidies that complicated their internal rate of return calculations.

Rubin found that, like the minority-focused venture funds, most community development venture capital funds were generalists, investing in a broad range of industries, including technology. This largely reflected their geographic concentration, which limited their deal flow and precluded their ability to specialize by industry (Rubin 2001, 2009).

Social venture capital

Social venture capital (SVC) funds invest in companies that manufacture or sell socially beneficial products and/or utilize a progressive management approach that benefits employees and customers. Some SVC funds also invest in companies created to provide revenue for nonprofit organizations or otherwise pursue primarily social objectives.

Social venture capital funds first emerged in the early 1990s with the creation of Commons Capital and Calvert Social Venture Partners, and of Investors’ Circle, an individual and organizational investors’ network. Each of these entities pursued both social and financial goals in their investment decision-making. The formation of additional self-identified SVC funds in the mid-to-late 1990s may have been hampered by the growth of community development venture capital, as many of the CDVC funds formed during that time period had similar objectives to social venture capital funds. The presence of a CDVC trade association and the relative availability of funding for new CDVC funds may have encouraged those interested in starting a venture capital fund with both social and financial objectives to self-identify as community development venture capital. More recently, as the CDVC brand has weakened, newly formed funds with both social and financial objectives, such as Good Capital and TBL Capital, have adopted the social venture capital label.

There currently are more than 20 self-identified social venture capital funds in formation or actively investing in the United States. Determining an exact number is complicated by the field’s blurry boundaries. In addition to the overlapping
objectives of some community development and social venture capital funds, there are social venture funds that invest in domestic companies versus those that invest primarily in the developing world, focusing on products designed to alleviate poverty and raise the standard of living. Additionally, there are organizations that call themselves venture capital funds but provide capital primarily to nonprofit organizations. Finally, there are the Cleantech and LOHAS (lifestyle of health and sustainability) sectors of traditional venture capital, which invest in industries—such as environmentally beneficial technology and healthy foods—that also are popular with social venture capital funds.

The distinction between social venture capital and Cleantech or LOHAS funds appears to be primarily one of intent and self-identification, with the overwhelming majority of Cleantech and LOHAS funds pursuing a single bottom line of profit maximization while SVC funds pursue both social and financial returns. In fact, venture capital funds targeting social, LOHAS, and Cleantech opportunities often invest in the same companies and even in syndication with each other, attracted by different aspects of a particular investment opportunity.

A recent $10.4 million investment round in the beverage maker Adina for Life, Inc., demonstrates such syndicated investments and the benefits they can bring for all involved. Adina for Life is a beverage maker that pursues a triple bottom line of ‘profitability, socially responsible business practices, and sustainability’ (Adina 2008). The round was led by Sherbrooke Capital, a profit-oriented LOHAS venture capital fund. Other investors included the social venture capital fund Good Capital and the social and community development venture capital fund Pacific Community Ventures.

For Sherbrooke, the Adina investment was attractive because of its potential for financial returns. As Sherbrooke’s Managing General Partner John Giannuzzi indicated, Adina had ‘done a terrific job of developing great tasting, better-for-you products that are differentiated and unique’, and Sherbrooke’s management believed there was ‘a tremendous [market] opportunity for such products’ (Sherbrooke Capital 2008). The investment appealed to Good Capital because of Adina’s triple bottom line business practices, and specifically its commitment to fair trade. The investment was also attractive to Good Capital because of a commitment by Adina and its investors to create ‘a charitable foundation to support the empowerment of women through entrepreneurship in Africa and the rest of the developing world’ (Good Capital 2008a). These social benefits were also important to Pacific Community Ventures. Additionally, as both a social and a community development venture capital fund, which ‘is committed to creating quality jobs for low and moderate income workers in addition to delivering strong financial returns to its fund investors’, PCV saw the Adina investment as an opportunity to ‘create quality . . . jobs’ in California as Adina’s operations were expanded (Penelope Douglass as quoted in Pacific Community Ventures 2008).

Receiving an equity investment from a syndicate that included social venture capital funds also made sense for Adina, beyond the syndicate’s ability to deliver expansion capital. The Adina brand is built upon a progressive message aimed at socially conscious customers. Its product tagline is ‘drink no evil’ and its advertising states: ‘We search the globe for the best Fair Trade suppliers, co-ops and organic family farms. That means our ingredients are healthy for you — and the world’ (Adina 2008). An association with Good Capital and Pacific Community Ventures signals that this social progressivity is more than a marketing tactic while
Sherbrooke’s involvement indicates that the company also has good financial performance prospects. Sherbrooke’s Giannuzzi confirmed the business importance of including social venture capital funds in the mix when he stated that ‘Organic and Fair Trade are critical elements of what makes Adina more than just another beverage company, and we believe that Good Capital’s contributions will be helpful in expanding demand for Adina’s products’ (Good Capital 2008a).

The financial return expectations of social venture capital funds are diverse and reflect the degree to which their business models deviate from those of traditional venture capital. Funds like Good Capital, which invests in both for-profit and nonprofit companies with a social mission, expect only ‘to return capital to investors with some upside’ (Good Capital 2007). New Cycle Capital, on the other hand, believes that it ‘can deliver outsized returns for [its] investors’ by investing in ‘non-energy generation businesses that take advantage of the economic dislocation resulting from new energy and resource usage patterns’ and in ‘businesses and entrepreneurs who either focus on lower-income and ethnic populations or lack access to traditional sources of risk capital’ (New Cycle Capital 2008).

Despite these funds’ disparate financial return expectations, their sources of capital appear fairly homogeneous. Both Good Capital and New Cycle Capital, for example, are capitalized by ‘high-net worth individuals and family foundations’ that support their social objectives (New Cycle Capital 2008; Good Capital 2008b). Most social venture capital funds lack the geographic investment parameters and economic development objectives that would enable them to receive investment capital from banks motivated by the Community ReinvestmentAct or from state and federal governments. They also are too new to have demonstrated the financial returns necessary to attract more traditional sources of capital, such as pension funds.

**Part III: A conceptual framework for developmental venture capital**

Given the fuzzy boundaries that separate the four types of developmental venture capital funds, it is not surprising that investors, policymakers and industry observers are sometimes confused about what differentiates these funds from each other. Fairchild (2007) finds evidence of this in his research on the minority-focused venture capital industry:

many of the funds’ investment professionals expressed frustration with confusion they experienced in explaining the explicitly investment-driven objectives of their funds relative to the related, but mission-driven Community Development Venture Capital funds … These managers viewed their peers as mainstream, economically oriented private equity firms, and many felt that equating their funds with community-development funds reflected a belief that minority markets were not viable investments on economic terms alone … Another frequently expressed frustration was that potential fund investors with a ‘social’ orientation were often surprised by the market-rate compensation demanded by the investment teams. Finally, some felt that such confusion diminished the interests in larger funds in co-investing in the industry, and my own research shows an unusually high level of syndication with other minority-targeted funds. (Fairchild 2007, 80)

In addition to making it more difficult for developmental venture funds to raise capital from institutional investors, such confusion can impede the development of effective public policies to address inadequate access to venture capital by
underserved populations and geographies. There clearly is a need to better understand what differentiates the economic and organizational models used by developmental venture capital funds.

In this part of the article, I argue that the primary distinction among developmental venture capital funds is between corrective funds, which try to address inadequate access to traditional venture capital by specific geographies and populations, and additive funds, which aim to further specific social objectives, such as fighting poverty and environmental degradation. I further differentiate between two forms of corrective venture capital based on the obstacles to capital access that each is trying to address, and whether the resulting economic models require subsidy (see Table 1).

**Corrective developmental venture capital**

Corrective developmental venture capital funds are designed to address the inability of certain populations and geographies to access equity capital from traditional venture capital funds. The underserved populations include women and people of color. As of 1998, women entrepreneurs received less than 5% of venture capital investments (Greene et al. 2001). Similarly, Bates and Bradford (1992) found that people of color were very limited in their access to venture capital, even when controlling for other variables.13

The underserved geographies are primarily rural and distressed. The 18 states that received the least venture capital dollars between 2005 and 2007 were poorer and more rural than the country as a whole (Rubin 2009). However, most cities outside the 40 largest US metro areas and distressed larger cities also are underserved by traditional venture capital (Carlson and Chakrabarti 2007).

Corrective developmental venture capital funds include minority-focused, state-sponsored and community development venture capital. Minority-focused venture capital funds were created to address the difficulties that entrepreneurs of color faced in accessing venture capital. State-sponsored and community development venture capital funds were created to address the lack of traditional venture capital in many US geographies.

Although they are all underserved by traditional venture capital, these populations and geographies are underserved for different reasons. Leaving aside possible discrimination, the most likely reason that minority and female entrepreneurs are underserved is the information failure that results from a lack of network commonality between minority and female entrepreneurs and the primarily

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<th>Corrective = Address inadequate access to traditional venture capital by specific geographies and populations</th>
<th>Additive = Further specific social objectives, such as fighting poverty and environmental degradation</th>
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<td>Does not require subsidy</td>
<td>Requires subsidy</td>
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<td>Minority-focused VC</td>
<td>Community development VC</td>
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Table 1. Developmental venture capital funds.
white and male venture capital industry. Venture capitalists rely heavily on their networks in identifying investment opportunities, conducting due diligence on those opportunities, and monitoring investment performance (Mason 2007). Since traditional venture capitalists’ networks include few women and people of color, they have limited access to and understanding of companies owned by these populations. This translates into higher search costs in identifying, conducting due diligence on, and monitoring firms owned by women and people of color (Brush et al. 2001, 2004).

Minority-focused venture capital funds are able to avoid these higher search costs by consciously building networks that include entrepreneurs of color. These networks enable them to learn about investment opportunities that traditional venture capital providers do not know exist and to evaluate these opportunities without increasing their transaction costs and lowering their financial returns (Bates and Bradford 2002, 2003a, 2003b, 2007, 2008; Bates, Bradford, and Rubin 2006). As a result, the most successful SSBICs and the majority of private minority-focused venture capital funds are no longer developmental in nature. Instead, they have a single bottom line of profit maximization. These funds view their focus on minority-owned and managed firms as a form of specialization, similar to the specialization that other venture capital funds have developed in biotechnology or energy.

Rural and distressed urban geographies also face imperfect information, in the form of inadequate networks to the mainstream venture capital community. However, these markets present additional barriers to venture capital investors. These include:

- limited profitable investment and exit opportunities (Freshwater et al. 2001; Barkley and Markley 2001; Barkley 2003; Carlson and Chakrabarti 2007; Rubin 2008a);
- the absence of a developed investment infrastructure, entrepreneur support networks and entrepreneurial culture (Freshwater et al. 2001; Barkley and Markley 2001; Barkley 2003; Hughes, Mallory, and Szabo 2004; Carlson and Chakrabarti 2007);
- greater difficulty and travel time for venture capital investors to reach their portfolio companies (Brophy 1997; Freshwater et al. 2001; Barkley and Markley 2001; Carlson and Chakrabarti 2007);
- higher levels of crime (Carlson and Chakrabarti 2007);
- limited access to specialized workforces and experienced management (Barkley and Markley 2001; Barkley 2003; Carlson and Chakrabarti 2007);
- a lack of understanding of how venture capital works (Freshwater et al. 2001; Barkley and Markley 2001) and willingness to give up company ownership (Freshwater et al. 2001; Barkley and Markley 2001; Hughes, Mallory, and Szabo 2004; Rubin 2008a) on the part of local entrepreneurs.

These barriers translate into higher transaction and operating costs – and lower rates of financial return – that purely profit-oriented investors are not willing to absorb. As a result, distressed urban and rural geographies attract primarily state-sponsored and community development venture capital funds, which invest in these geographies to meet their social objectives. These developmental venture capital funds use public and private sector subsidies to offset the higher transaction and operating costs (Rubin 2008a). Public sector subsidies take the form of direct appropriations, tax credits, or mandates such as the Community Reinvestment Act.
Private sector subsidies take the form of foundation grants and lower returns to investors (Rubin forthcoming).

**Additive developmental venture capital**

*Additive* developmental venture capital funds use their investments and their influence as equity investors to further specific social objectives, such as fighting poverty and environmental degradation or promoting progressive management practices in the workplace. They do so by investing in companies that produce or sell socially beneficial products and by encouraging the companies in which they invest to maximize their social impact through progressive employee and environmental practices. Additive developmental venture capital funds include social venture capital funds. They also include those community development venture capital funds that combine both corrective and additive objectives, by investing in companies located in distressed geographies that generate additional social returns, such as producing environmentally beneficial products or promoting progressive management practices.

The emergence and recent growth of additive DVC funds was made possible by, and mirrors, the rise of the socially responsible investment and social enterprise movements. Socially responsible investing (SRI) is an ‘approach to investing that . . . considers both the investor’s financial needs and an investment’s impact on society’ (Social Investment Forum 2008). The practices of additive DVC funds are consistent with those of other SRI investors who invest in companies that pursue socially beneficial objectives and encourage the companies in which they invest ‘to improve their practices on environmental, social, and governance issues’ (Social Investment Forum 2008).

The social enterprise movement ‘challenges old sector boundaries and encourages innovative approaches [to solving society’s problems] using the tools from any sector that are most likely to be effective’ (Dees 2008, 120). By increasing awareness and acceptance of cross-sectoral approaches to social problems, the social entrepreneurship movement helped legitimize the mixture of social and financial objectives and the hybrid organizational forms used by additive DVC funds. Additionally, the growth of social entrepreneurship, like that of additive developmental venture capital, has been propelled partly by the proliferation of new wealth from financial and high-tech entrepreneurs, who believe that business models offer viable paths for advancing social objectives (Rangan, Leonard, and McDonald 2008).

Additive developmental venture capital also reflects a recognition on the part of both fund managers and social investors that the limited supply of equity capital and the rights granted to equity investors (such as seats on a portfolio company’s board of directors) give venture capitalists a particularly strong ability to influence a portfolio company’s actions. This influence can be used to pursue social as well as financial objectives. This recognition is reflected in the social objectives of many community development venture capital (CDVC) funds formed in the mid-to-late 1990s. In addition to investing in companies that created jobs for low-income individuals, these funds also targeted companies that adhered to socially progressive management practices and provided their workers with health care and other benefits. Some CDVC funds even made incorporation of such progressive management practices a condition of investment (Rubin 2001).
Most additive developmental venture capital funds do not invest in specific distressed geographies, so they do not have to overcome the higher transaction costs that inhibit the profitability of the geographically developmental venture capital funds. Nevertheless, the institutional investors that capitalize traditional venture capital funds tend to view the additive DVC funds’ social bottom line as a signal of lower financial returns, unless and until the funds can demonstrate otherwise. This reluctance has made it difficult for the newer additive DVC funds, which do not have a record of financial returns, to raise capital from institutional sources. Instead, the newer funds are turning to wealthy socially responsible investors and some foundations for their capital. The next five to ten years will determine whether they are able to generate the financial and social returns necessary for long-term survival.

Part IV: Conclusions

The developmental venture capital industry consists of venture funds that pursue both social and financial objectives. This article details the four sub-sectors that make up the industry – minority-focused venture capital; state-sponsored venture capital; community development venture capital and social venture capital – and proposes a theoretical framework that distinguishes between these four sub-sectors on the basis of the social objectives that each is trying to accomplish.

Specifically, the framework differentiates between developmental venture capital funds that have additive objectives and those that have corrective objectives. Venture capital funds with corrective objectives, which include minority-focused, state-sponsored, and community development venture capital funds, seek to address inadequate access to traditional venture capital by specific geographies and populations. Venture capital funds with additive objectives, which include social and some community development venture funds, seek to further specific social goals, such as reducing poverty and environmental degradation.

The framework further differentiates between corrective venture capital funds that target populations versus geographies, based on whether the resulting economic models require subsidy. Minority-focused venture funds serve entrepreneurs of color, whose access to equity capital has been constrained by information failure that resulted from a lack of network commonality between them and the primarily white members of the venture capital industry. Minority-focused venture funds have been able to overcome this information failure without subsidy by developing specialized networks that include entrepreneurs of color. As a result, they have been able to demonstrate the financial returns necessary to attract investment capital from pension funds and other institutional sources (Bates and Bradford 2002, 2003a, 2003b, 2007, 2008; Bates, Bradford, and Rubin 2006).

In contrast, most state-sponsored and community development funds serve rural and distressed urban geographies, which present additional transaction and operating costs that are more expensive to overcome. These include limited opportunities for investment and profitable exits from investment; the absence of a developed investment infrastructure, entrepreneur support networks and entrepreneurial culture; greater difficulty and travel time for venture capital investors to reach their portfolio companies; limited access to specialized workforces and experienced management; and entrepreneurs who lack an understanding of how venture capital works and are unwilling to give up ownership in their companies.
Offsetting these additional costs requires subsidy, either from investors who are willing to accept lower financial returns or from public or private sector grants.

Additive developmental venture capital funds are meant to further specific social goals, such as reducing poverty and environmental degradation. Both social venture capital funds and some community development venture capital funds pursue such objectives. Unlike community development venture capital funds, however, social venture funds do not target their investments to rural and distressed urban geographies. As a result, they do not require subsidy to overcome the higher transaction costs that limit investments in such areas. Because social venture capital funds are relatively new and financially unproven, however, they have found it challenging to raise capital from traditional institutional sources, and have turned to more socially motivated investors, such as foundations and socially conscious wealthy individuals.

This article provides valuable tools for both public policy and practice. By highlighting the higher transaction costs faced by certain kinds of developmental venture capital funds, it can assist policymakers seeking to increase access to venture capital for specific geographies and populations to target available subsidy dollars more effectively. By clarifying the differences between sub-sectors of developmental venture capital, the article can help to resolve investor confusion and facilitate fundraising by individual DVC funds.

More broadly, this framework is intended to foster a more open dialogue about the appropriate role for subsidy in developmental finance and the formulation of a clear and consistent rationale for such subsidy. In addition to increasing understanding of the present uses and justifications for subsidy, such a dialogue can help raise awareness of hidden subsidies, such as those utilized by Daniels and Nixon’s second generation funds, highlighting the inconsistencies in how programs are currently evaluated. Ideally, such a dialogue will lead to the creation of more efficient and effective developmental venture capital programs that can best deliver their intended objectives.

Notes
1. ARD was formed in 1946 by MIT president Karl Compton, Federal Reserve Bank of Boston president Ralph Flanders, Massachusetts Investors Trust chair Merrill Griswold and Harvard Business School Professor General Georges F. Doriot (Gompers 1994).
2. Although Brooke’s comment could be seen as a post facto rationalization, the role of social objectives in driving the early venture capital industry is well documented – see Lerner (2009).
3. Based on estimated capitalizations of the four developmental venture capital sub-sectors.
4. Both the Small Business Investment Company (SBIC) and Specialized Small Business Investment Company (SSBIC) programs were created by Congress and managed by the United States Small Business Administration. SBICs were designed to increase the overall supply of venture capital (Gompers 1994) while SSBICs were designed to provide minority entrepreneurs with access to equity and debt capital (Bates 1997a). SSBICs’ mission was subsequently broadened to serve all socially or economically disadvantaged entrepreneurs (SBA 2001).
5. Clark and Gaillard received 76 responses to the 1254 surveys they mailed, for a response rate of 6%. After cleaning the data, the responses were reduced to 59, for a response rate of less than 5%.
6. The Community Reinvestment Act (CRA) was enacted by Congress in 1977 in order to encourage regulated financial institutions to fulfill their ’continuing and affirmative
obligations to help meet the credit needs of the local communities in which they are chartered’ (NCRC 2008).


8. A subset of minority-focused venture capital funds also invest in companies managed by people of color or located in urban markets.

9. NAIC was originally known as the American Association of MESBICs. Its name was changed in the 1980s to the National Association of Investment Companies (NAIC).

10. In addition to community development venture capital funds, CDFIs include community development loan funds, community development credit unions, and community development banks. For more on CDFIs see Benjamin, Rubin, and Zielenbach (2004).

11. In addition to the creation of the CDFI Fund, CDVC fundraising also was helped by the 1995 revisions to the Community Reinvestment Act that, in combination with increasingly intense consolidation in the banking industry, led to a broadly perceived strengthening of the CRA. The bank consolidation ‘provided greater opportunities for community organizations and regulators to evaluate bank and thrift performance under CRA in the context of merger applications’ (Barr 2005, 113). For more on this see Rubin (2008b).


13. Bates and Bradford’s conclusion is based on their analysis of the 1982 Characteristics of Business Owners Survey. Although more recent research on this topic is not available, both the increase in women’s access to equity that occurred between 1993 and 1998, and the growth in the number and capitalization levels of private equity funds that focus on entrepreneurs of color, suggest that access to equity capital likely has improved for people of color over the last 26 years. On the other hand, a large gap still exists in access to credit for African-Americans and Latinos and could mean that a similar gap continues in their access to equity capital. There clearly is a need for more current research on this topic.

14. The network commonality hypothesis is consistent with the findings of Brush et al. (2001 and 2004) as to why women entrepreneurs are disproportionately underserved by venture capital providers. It is also consistent with Bates and Bradford’s (2007) findings that minority-focused venture capital fund managers identify the bulk of their investment opportunities through relationship networks that are different from those utilized by conventional venture capital. The hypothesis is further supported by the strong financial performance of minority-focused venture capital funds, which undermines the alternative explanation that companies owned by entrepreneurs of color are underserved because they do not represent a financially attractive investment opportunity (Bates and Bradford 2002, 2003a, 2003b, 2007, 2008; Bates, Bradford, and Rubin 2006).

15. Socially responsible investments include one or more of the three core socially responsible investing strategies – screening, shareholder advocacy and community investing. For more, see Social Investment Forum (2008).

16. Between 1995 and 2007, socially responsible investment (SRI) ‘assets increased more than 324%, from $639 billion . . . to $2.71 trillion’ (Social Investment Forum 2007, ii). They now account for 11% of total assets under management. The Social Investment Forum estimates that, as of 2007, approximately $5.3 billion of SRI assets were invested in ‘socially or environmentally screened alternative investment vehicles, such as social venture capital, double- and triple-bottom-line private equity, and hedge funds’ (Social Investment Forum 2007, iii).

17. The Social Enterprise Movement ‘emerged in the final decades of the twentieth century and has been accelerating into the twenty-first’ (Dees 2008, 120).

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